



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Introduced:	02/23/07	Bill No:	<a href="#">AB 1681</a>
Tax:	Sales and Use	Author:	Houston
Related Bills:	AB 1152 (Niello) AB 1206 (Smyth) SB 359 (Runner & Dutton)		

## BILL SUMMARY

This bill would, beginning on the first January following the fiscal year in which the state budget deficit for the 2008-09 fiscal year is eliminated, provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified.

## ANALYSIS

### CURRENT LAW

Under current law, entities engaged in activities such as manufacturing, research and development, telecommunications, and power generation activities that make purchases of equipment and other items for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for these entities.

The statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

**PROPOSED LAW**

This bill would add Section 6377 to the Sales and Use Tax Law to provide a state sales and use tax exemption (5.25%) operative January 1, 2008, or the first January following the fiscal year in which the state budget deficit for 2008-09 is eliminated, for the following purchases by a “qualified person”:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).
- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any qualifying manufacturing or research and development equipment.
- Tangible personal property purchased to be used primarily in the telecommunication industry.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described, or as a research or storage facility used in manufacturing.

The bill would define a “qualified person” as any person primarily engaged in manufacturing activities, as described in the North American Industry Classification System Manual (NAICS) Sector 31-33, telecommunications activities as described in NAICS Sector 513310 to 513390, and electrical generation activities, for commercial use, that are described in NAICS Codes 22111 to 221122.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The bill would provide that the exemption would remain in effect only for seven years after it first becomes operative, and will be repealed on January 1 of the first year thereafter.

As a tax levy, the bill would become effective immediately upon enactment.

**BACKGROUND**

For a ten-year period ending December 31, 2003, the law provided a partial sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal Standard Industrial Classification codes. The exemption applied to the state tax portion of the statewide rate for sales and purchases of qualifying property, and the in lieu income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and

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development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property." New manufacturers could receive either the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This partial sales and use tax exemption and income tax credit had a conditional sunset date. The sunset was to occur in any year following a year when manufacturing employment (as determined by the Employment Development Department) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was less than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

The sales and use tax partial exemption for new manufacturers and the income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

Since the expiration of these tax incentives, numerous measures have been introduced to either reinstate or to expand or modify the incentives. Listed below are similar measures considered during the 2005/06 Legislative Session:

- AB 80 (Houston) – similar to AB 1681, was held in the Assembly Revenue and Taxation Committee.
- AB 2218 (Torrico) - would have, for a 10-year period beginning January 1, 2007, provided a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined. The bill was held in the Assembly Appropriations Committee.
- AB 2395 (Villines) - would have provided, for calendar years beginning on or after January 1, 2006, a state sales and use tax exemption for tangible personal property, as defined, purchased for use by manufacturers that have "gross aggregate gross assets" used in the manufacturing activity not exceeding \$5 million. The bill would also have provided a corresponding 6 percent income tax credit on purchases of similar property. The bill was held in the Assembly Revenue and Taxation Committee.
- AB 2595 (Arambula) - would have, among other things, required the Board to grant a "small size manufacturer," as defined, a "sales and use tax offset," as defined, against that manufacturer's tax liability, as specified. The bill was gutted and amended to become a proposed training initiative to increase workers' skills in manufacturing and goods movement and was ultimately vetoed by the Governor.
- SB 1291 (Alquist) - would have provided a state sales and use tax exemption (5.25 percent) for purchases on or after January 1, 2006, of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor,

biotechnology and pharmaceutical clean rooms and equipment. This measure died in the Senate Revenue and Taxation Committee.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

#### Arguments Supporting the MIC

- **Investment Incentive** — The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- **Relocation Incentive** — California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- **Efficient Job Allocator** — Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- **Other Arguments.** Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

#### Arguments Against the MIC

- **Inequitable Taxation** — The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- **Relocation Rather Than Creation** — The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of “prisoners’ dilemma”—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.

- **Inefficient Development Policy** — Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives “windfall benefits” in the form of reduced taxes.
- **Ineffective Development Policy** — Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the American Electronics Association. According to the author’s office, its purpose is to reinstate the tax incentives available to manufacturers and to provide new tax incentives to telecommunications entities and power generators.
2. **What are the criteria to determine whether the 2008-09 budget deficit is eliminated?** Some ways in which budget deficits have been dealt with in the past include various accounting changes, such as fund transfers or spending deferrals. Some have argued these changes do not eliminate the budget deficit, but rather, postpone problems for later years. In order to avoid any uncertainty with respect to when the 2008-09 budget deficit is actually eliminated, perhaps the Department of Finance or a legislative budget committee should make that certification to the Board.
3. **Many telecommunication companies may not be currently registered with the Board.** The bill references NAICS Codes 513310 to 513390 for purposes of identifying the telecommunication entities that would be included within the proposed exemption. These entities include not only the typical telecommunications companies, such long distance carriers, cellular phone carriers, etc., but also those primarily engaged in such activities as paging services, earth stations for satellite communication carriers, resellers of satellite telecommunications, ship-to-shore broadcasting communications carriers, microwave telecommunications resellers, and others. Many of these entities may not be registered with the Board, since they are not engaged in the business of making sales of tangible goods.
4. **Technical issues:**
  - *Limited exemption for leased property.* Proposed subdivision (g) (page 5, line 25) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to *new* manufacturers’ leases of equipment. Since this bill would provide the exemption for all qualifying entities, it appears the limitation in subdivision (g) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

- *The definition of “primarily” should be revised.* Although the Board administered the previous exemption for a 10-year period, some ambiguities in the statute caused confusion and perhaps should be addressed with the enactment of this measure. For example, the bill lacks a definition for the word “primarily” as it is used in proposed Section 6377(c)(6). The definition for “primarily” provided in proposed Section 6377(c)(3) only address the issue of when property is primarily used in a specific activity. It does not address the issue of whether the person claiming the exemption (i.e., the taxpayer) is primarily engaged in the required activities. This is an important issue and one that generated a lot of disputes when the Board administered Section 6377 previously. The following amendments to paragraph (3) of subdivision (c) of proposed Section 6377 to address this issue is recommended

6377(c)(3) “Primarily” as used in subdivisions (a) or (b) means tangible personal property used 50 percent or more of the time in an activity described in those subdivisions subdivision (a). “Primarily” as used in subdivision (c) means the qualifying person is engaged in the activities described in that subdivision 50 percent or more of the time.

- *Useful life should be clarified.* Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 4, lines 14 and 28, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference should be incorporated into the bill to the provision in the California income tax laws for depreciating assets.
  - *Updated NAICS codes should be considered.* For purposes of describing the qualifying entities, the bill refers to the NAICS codes from the 1997 edition. However, since the NAICS codes have been updated in the 2002 edition, perhaps the author may wish to use more updated code references.
  - *Minor change.* As a minor technical amendment, on page 2, line 19, “(1) or (2).” should replace “(1), (2) or (3).”
5. **Related measures.** Other measures that would provide an exemption for manufacturing and other related activities include:
- AB 1152 (Niello) would, beginning January 1, 2008, provide a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by persons engaged in manufacturing and software production, as specified and defined.
  - AB 1206 (Smyth) would provide a state sales and use tax exemption for sales and purchases of machinery and equipment used in research and development activities, as specified.
  - SB 359 (Runner and Dutton) would, among other things, provide a state sales and use tax exemption for machinery and equipment used in the manufacturing process by new manufacturers and software producers.

**COST ESTIMATE**

The Board would incur substantial costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, reviewing and processing returns, and programming. An estimate of these costs is pending.

**REVENUE ESTIMATE****BACKGROUND, METHODOLOGY, AND ASSUMPTIONS****Manufacturing**

The Annual Survey of Manufacturers, Geographic Area Statistics 2005, Table 3, a U.S. Census Bureau publication, provided that for NAICS 31-33 for California, machinery and equipment expenditures were \$11.2 billion. The bill also includes tangible personal property purchased in the performance of a construction contract for a qualified person who will use the tangible personal property as an integral part of the manufacturing process. Construction expenditures for "other structures" were about \$2 billion. We estimate that about half of the expenditures would amount to exempt installation labor charges. The bill also includes fuel used or consumed in the manufacturing process. The survey reported \$3.2 billion for purchases of fuels.

Machinery and equipment	\$11.2 billion
Construction contracts	1.0 billion
Fuel Consumption	<u>3.2 billion</u>
Total	\$15.4 billion

**Telecommunications**

The NAICS Codes 513310 to 513390 for telecommunications are no longer in use. According to the U.S. Census Bureau, now the new codes for this sector are 517110 to 517910.

The Annual Capital Expenditures 2005, Table 4a, U.S. Census Bureau publication, provided the equipment expenditure for telecommunications as follows:

Wired telecommunications carriers (NAICS 5171)	\$19.2 billion
Wireless telecommunications carriers (NAICS 5172)	\$10.9 billion
Telecommunications resellers, satellite, and other	
Telecommunications (NAICS 5173, 5174, & 5179)	\$ 3.2 billion
Total	\$33.3 billion

We estimate that California's annual expenditures amount to \$4.0 billion (\$33.3 billion x 12% California's population = \$4.0 billion).

**Electrical Generation**

The Annual Capital Expenditures 2005, Table 4a, U.S. Census Bureau publication, provided the NAICS Codes 22111 to 221122, electrical generation, was \$29.2 billion. We estimate that California's expenditures amount to \$3.5 billion (\$29.2 x 12% California's population = \$3.5 billion).

**California Expenditures – Summary**

NAICS	Classification	Equipment Expenditures
31 - 33	Manufacturing	\$ 15.4 billion
5171 - 5179	Telecommunications	\$ 4.0 billion
2211 - 22	Electrical Generation	\$ 3.5 billion
<b>Total</b>		<b>\$ 22.9 billion</b>

**REVENUE SUMMARY**

The annual revenue loss from exempting sales and purchases of \$22.9 billion from the state sales and use tax related to manufacturing, telecommunications and electrical generation activities is as follows:

	Revenue Loss (in billions)
General Fund (5%)	\$1.1
Fiscal Recovery Fund (.25%)	0.1
<b>Total</b>	<b>\$1.2</b>

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